



RETIRE
EARLY

with

REAL ESTATE

how SMART INVESTING *can*

help you ESCAPE THE 9-TO-5 GRIND *and*

DO WHAT MATTERS MORE

CHAD CARSON

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BiggerPockets®
PUBLISHING

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Retire Early with Real Estate

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TABLE OF CONTENTS

Introduction	12
Beginnings	
My Motivation to Retire Early Using Real Estate	
Put Money in Its Place	
The Money-Life Manifesto: Do What Matters	
The True Cost of Living	
A Life That Matters (My Definition)	
My Story: A Sprint up the Real Estate Mountain	
Why Massive Real Estate Empires Aren't Always Better	
Real Estate Investing Sweet Spots	
A Place Called "Enough"	
Profile of a Real Estate Early Retiree: Chad Carson	
How to Read This Book	
PART 1 WHY REAL ESTATE INVESTING?	27
Real Estate Investing Is an I.D.E.A.L. Vehicle for Early Retirement	
CHAPTER 1 Why Real Estate Is the I.D.E.A.L. Investment	28
Income	
Depreciation	
Equity	
Appreciation	
Leverage	
Profile of a Real Estate Early Retiree: Kat Horn	
CHAPTER 2 Four Reasons Early Retirees	
Should Invest in Real Estate	38
Control	
Timing	

Tax Benefits
Simple and Understandable
Profile of a Real Estate Early Retiree: Sam Dogen

PART 2 | A MAP OF THE FINANCIAL MOUNTAIN47

Destination: Early Retirement (aka Financial Independence)

CHAPTER 3 | Getting Clear on Your Early Retirement Destination ...48

Is “Retirement” the Right Word?
A Clear View of Financial Independence
Your Financial Independence Number
Profile of a Real Estate Early Retiree: Craig and Jane Horton

**CHAPTER 4 | How Much Wealth Do You Need
to Retire Using Real Estate?**55

No Real Estate Retirement Calculators Needed
Seven Debt-Free Properties and a Comfortable Early Retirement
Living Beautifully on \$58,800 Per Year
Profile of a Real Estate Early Retiree: Lisa Phillips

**CHAPTER 5 | Don’t Wait on Happiness:
Enjoy the Peak and the Plateaus**62

Plateau #1: Self-Sufficiency
Plateau #2: Mini-Retirement
Plateau #3: Semi-Retirement
Plateau #4: Early Retirement
Plateau #5: Traditional Retirement
Profile of a Real Estate Early Retiree: Mauricio Rubio

PART 3 | PREPARATIONS FOR THE CLIMB71

The Fundamentals of Building Wealth

CHAPTER 6 | The Story of the Savings Gap72

How to Become Rich
Profile of a Real Estate Early Retiree: Graham Stephan

CHAPTER 7 Simple Math = Shorter Path to Financial Independence	77
Profile of a Real Estate Early Retiree: Joe Olson	
CHAPTER 8 How to Control Your Expenses	83
Why You Should Cut the Big Expenses First	
You Can Afford Anything, But Not Everything	
Profile of a Real Estate Early Retiree: Paula Pant	
CHAPTER 9 How to Increase Your Income	90
Become an Expert	
Improve Your Communication Skills	
Become Invaluable Through Profound Service	
Develop Real Estate Side Hustles	
Profile of a Real Estate Early Retiree: Liz Schaper	
CHAPTER 10 The Five Wealth Stages: What's Yours?	98
1. Survival	
2. Stability	
3. Saver	
4. Growth	
5. Withdrawal	
Profile of a Real Estate Early Retiree: Seth Williams	
PART 4 THE FIRST STEPS	107
Starter Real Estate Wealth-Building Plans	
CHAPTER 11 The House Hacking Plan	109
Intro	
My First House Hack—Merry Christmas to You	
The Next Steps After Your First House Hack	
Profile of a Real Estate Early Retiree: Drew N.	
CHAPTER 12 The Live-In-Then-Rent Plan	118
Example of the Live-In-Then-Rent Plan	
Next Steps to a Live-In-Then-Rent Plan	
Profile of a Real Estate Early Retiree: Tony Crumpton	

CHAPTER 13 The Live-In Flip Plan	126
Example of the Live-In Flip Plan	
Next Steps of the Live-In Flip Plan	
Profile of a Real Estate Early Retiree: Mindy and Carl Jensen	
CHAPTER 14 The BRRRR Plan	136
Example of the BRRRR Plan	
Profile of a Real Estate Early Retiree: Brandon Turner	
PART 5 THE CLIMB	143
The Primary Real Estate Wealth-Building Plans	
CHAPTER 15 The Rental Debt Snowball Plan	144
Example of the Rental Debt Snowball Plan	
The Amazing Momentum of Debt Snowballs	
Benefits of the Rental Debt Snowball Plan	
The All-Cash Rental Plan	
Example of the All-Cash Rental Plan	
The Overall Results of the All-Cash Rental Plan	
Objections to the All-Cash Rental Plan	
Profile of a Real Estate Early Retiree: Richard Carey	
CHAPTER 16 The Buy and Hold Plan	159
The Long-Term Buy and Hold Plan	
Example of the Long-Term Buy and Hold Plan	
Results of the Long-Term Buy and Hold Example	
How to Successfully Harvest Your Long-Term Buy and Hold Properties	
The Short-Term Buy and Hold Plan	
Short-Term Buy and Hold Example: Buy-3-Sell-2-Keep-1	
Profile of a Real Estate Early Retiree: Greg and Holly Johnson	
CHAPTER 17 The Trade-Up Plan (Compounding Wealth Tax-Free) ..	176
Example of the Trade-Up Plan	
Final Thoughts on the Trade-Up Plan	
Profile of a Real Estate Early Retiree: Elizabeth Colegrove	

CHAPTER 18 How to Choose the Right Wealth-Building Plan for You	195
Ready to Start or Just Getting Started	
Own Some Properties, But Not Yet at Financial Independence Number	
Own Enough Properties or Already Have a Large Chunk of Wealth	
Don't Overthink. Just Go Build Some Wealth	
Profile of a Real Estate Early Retiree: Eric Bowlin	
PART 6 THE PEAK AND BEYOND	203
Strategies to Withdraw an Unending Supply of Early Retirement Income	
CHAPTER 19 An Early Retirement Withdrawal Plan That Lasts	204
Goals and Risks of the Withdrawal Phase	
The Four Percent Rule and Traditional Retirement Planning	
Don't Touch the Principal	
Profile of a Real Estate Early Retiree: Ricky Cameron	
CHAPTER 20 Build an Income Floor, Then Invest for the Upside	212
Sample Real Estate Income Floor + Upside Investing Portfolio	
Diversify Your Withdrawal Strategies	
Profile of a Real Estate Early Retiree: Dave Boroughes	
CHAPTER 21 The Role of Retirement Accounts for Early Retirees	222
Early Retirees and Retirement Accounts	
The Pre-60 and Post-60 Plans	
Types of Retirement Accounts	
The Best Investments Inside a Retirement Account	
Profile of a Real Estate Early Retiree: Felisa Savage	
CHAPTER 22 Retirement Account Optimization and Early Withdrawals	235
Required Minimum Distributions	
The Power of a Roth IRA Conversion in Early Retirement	
Roth Conversion Case Study: 45-Year-Old Early Retirees	

How to Access Retirement Funds Early (If Necessary)
Profile of a Real Estate Early Retiree: Lucas Hall

CHAPTER 23 | Early Retirement Backup Plans247

Expense Backup Plans
Income Backup Plans
Profile of a Real Estate Early Retiree: Matt B.

CHAPTER 24 | How to Have True Security in Early Retirement258

Invest in Your Greatest Asset (You!)
Be Flexible in Early Retirement
A Life Without Absolute Security
Profile of a Real Estate Early Retiree: Doug and Traci Burke

PART 7 | YOUR TURN TO CLIMB269

How to Get Started with Real Estate Early Retirement

CHAPTER 25 | The 5-Step Real Estate Early Retirement Plan270

Line Up Your Dominos
Step #1: Get Clear on Your Why (What Matters?)
Step #2: Calculate Your Financial Independence Number and Wealth Goals
Step #3: Determine Your Wealth Stage
Step #4: Pick Your Real Estate Wealth-Building or Retirement Income Plan
Step #5: Get Started!
Strategy, Tactics, and Additional Resources
Profile of a Real Estate Early Retiree: Douglas Orr

CHAPTER 26 | Final Thoughts279

The Sting of Regret and the Joy of Freedom
Remember the Purpose of Plans
Commit to the Process
Acknowledgements

APPENDIX | Real Estate Early Retirement Survey Results286

PART 1

WHY REAL ESTATE INVESTING?

*Real Estate Investing Is
an I.D.E.A.L. Vehicle for
Early Retirement*

CHAPTER 1

WHY REAL ESTATE IS THE I.D.E.A.L. INVESTMENT

People are always blaming their circumstances for what they are. I don't believe in circumstances. The people who get on in this world are the people who get up and look for the circumstances they want, and, if they can't find them, make them.

—GEORGE BERNARD SHAW

As you probably know, climbing the financial mountain isn't unique to real estate investing. Just like there are multiple paths up a mountain, there are other vehicles to get there that have been used by successful early retirees. For example, you could use dividend stocks, bonds, small businesses, index funds, bank CDs, and more to climb to your goals.

But of all these choices, real estate investing is my favorite. And my guess is you like it too since you've picked up this book! Real estate investing is a perfectly suited vehicle for aspiring early retirees. It gives you an incredible amount of control over the method and the timing of your exit from the rat race. Let me explain why by showing how real estate investing is I.D.E.A.L.

I learned this acronym in the first real estate book I read after college. And I have yet to find a better way to explain the core benefits of real estate

investing. I.D.E.A.L. tells you the primary ways you can profit with investment properties:

- Income
- Depreciation
- Equity
- Appreciation
- Leverage

I'll explain each one in more detail.

Income

Income is the core benefit of real estate investing. Even the worst rentals I have produce more income than equivalent amounts of money in other assets like stocks or bonds. For example, on March 2, 2018, the dividend rate of the S&P 500 (a group of major stocks) was 1.82 percent.¹ And the interest yield of a ten-year United States Treasury bond (the lowest-risk type of bond and is essentially a loan to the government) on the same date was 2.86 percent.²

But in the right markets, I often see unleveraged (no debt) income returns of 5 to 10 percent with rental properties, even after paying all expenses, including a property manager. And with safe, long-term leverage (if you choose to do that) you can sometimes see those income returns double to 10 to 20 percent or more.

To put that into perspective, here's a chart comparing actual yearly income (pretax) for an S&P 500 index fund, a ten-year U.S. Treasury bond, and an unleveraged rental property with a 7 percent income yield.

ASSET TYPE	INCOME YIELD	INCOME/YEAR FOR \$100,000 INVESTMENT
S&P 500 Index Fund	1.82%	\$1,820
10-Year U.S. Treasury Bond	2.86%	\$2,860
Unleveraged Rental Property	7%	\$7,000

¹ "S&P 500 Dividend Yield Statistics." Last modified March 2, 2018. www.multpl.com/s-p-500-dividend-yield/.

² "10-Year U.S. Treasury Bond Statistics." Last modified March 2, 2018. www.multpl.com/10-year-treasury-rate/.

That's an *enormous* difference! A \$1 million portfolio invested 100% in real estate at those numbers would receive \$70,000 per year before tax. While the same amount in stocks would produce \$18,200, and in U.S. Treasury bonds would produce \$28,600. As an early retiree living off of your assets, which would you prefer? More income or less?

And the income from an unleveraged portfolio of quality rentals is very flexible. Prices and rents of quality real estate tend to keep up with inflation. And unleveraged properties, as in this example, can possibly survive deflationary environments if rents go down. But most of all, consistent, steady income from rentals is the Holy Grail for early retirees. That income allows you to live, explore, and do what matters.

Depreciation

Do you ever get excited about the U.S. Tax Code? Well, me either ... until now! As of this writing, the U.S. government requires real estate investors to spread out most of the cost of real estate purchases over 27.5 years (for residential property).³ This creates what's called a depreciation expense, which can shelter or protect your income from taxes and reduce your tax bill.

Why does this happen? Unlike other business expenses, depreciation doesn't actually come out of your bank account. It's a paper loss. But this paper expense can still offset taxable income and save money on your tax bill. Here is a basic example.

Scenario #1 (without depreciation expense):

\$10,000 taxable rental income x 25% federal income tax rate = \$2,500 taxes owed

Scenario #2 (with depreciation expense):

\$10,000 rental income – \$3,000 depreciation expense = \$7,000 taxable rental income

\$7,000 x 25% federal income tax rate = \$1,750 taxes owed

Tax Savings = \$2,500 – \$1,750 = \$750

The higher your tax rate, the more taxes you would save in this example. Depreciation is not unique to real estate, but real estate investing uniquely

³ "Publication 946 (2016), How to Depreciate Property." Last updated September 11, 2017. www.irs.gov/publications/p946#en_US_2013_publink1000107524.

benefits from depreciation. Why? Because the cost of real estate is so large and often purchased with debt. A \$250,000 building depreciated over 27.5 years provides a tax shelter of \$9,091 per year. If you had three rental properties at that cost, you'd shelter \$27,273 of income from taxes and *possibly* save \$6,818 on your tax bill (at a 25 percent rate).

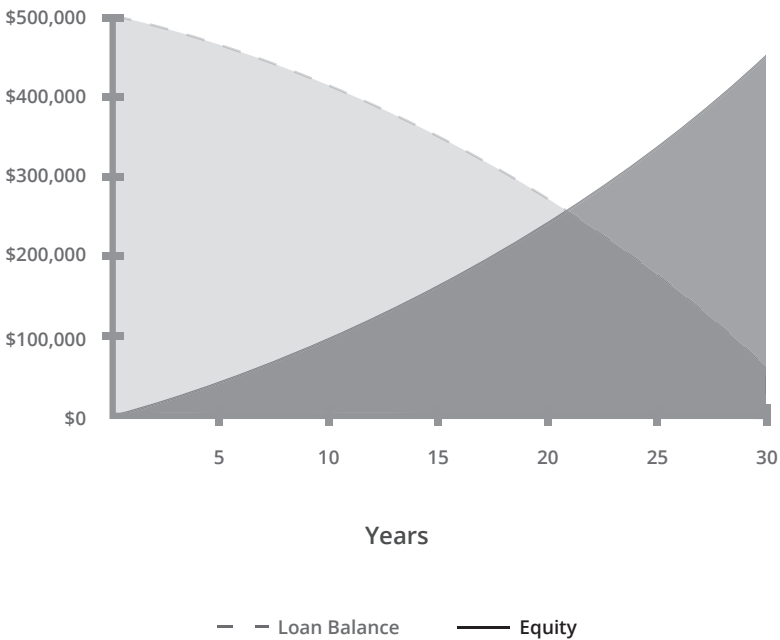
I say “possibly,” because this is a nuanced part of the tax code. There are several layers of rules that affect real estate tax deductions. That's beyond the scope of this book, so for now I'll just say that a CPA (certified public accountant) who specializes in real estate investing is a must-have on your personal real estate team.

And keep in mind that what the IRS giveth, the IRS taketh away. When you sell a rental property, it's very likely that you'll have to recapture the depreciation and pay taxes on it. The tax rate on this recaptured real estate depreciation is typically 25 percent (as of 2018). This creates a big incentive to keep real estate or to use other tax-savings strategies when selling, like a 1031 exchange. I'll discuss the 1031 exchange later in Chapter 17, “The Trade-Up Plan.”

Equity

This benefit is one of my *favorite* parts of real estate investing. If you borrow money to purchase your investment property and have at least break-even cash flow, your tenant essentially pays off your property for you. Explained another way, one part of a typical mortgage payment is principal paydown on your mortgage. So, if you have enough rental income to pay your expenses and your mortgage, the tenant is working hard to increase *your* equity in the property.

Equity Buildup & Loan Paydown Over Time



I don't know about you, but I love the idea of other people working hard to build my net worth! And the tenants also get great value in return. They get to live in a nice, clean, well-cared-for rental property, and they get to deal with a fair property owner. It's a clear win-win.

Appreciation

Over many years, real estate tends to appreciate (increase in price) at the same rate as inflation (1–2 percent per year) on average.⁴ Of course, real es-

⁴ www.inflation.eu/inflation-rates/united-states/historic-inflation/cpi-inflation-united-states.aspx.

tate is very local, so the actual rate can vary widely from place to place. But when any kind of appreciation is combined with the other benefits already discussed, the total return can be very attractive.

For example, if your unleveraged property produced 7 percent income returns and 3 percent appreciation, your long-term return could average around 10 percent (ignoring tax costs or benefits for the moment). But this passive type of appreciation does not tell the whole story. The *real* power of appreciation in real estate is the type of price increase you can control.

First, appreciation can often be built into a purchase of real estate from the beginning. If you are out looking for properties all the time, you will be able to find bargains purchased below full value. For example, if you buy a property normally worth \$200,000 at a 10 percent discount, you've built in appreciation of \$20,000 from day one.

Second, there is a concept called forced appreciation. This means that you do something to the property in order to increase its value. This is where the entrepreneur in you can shine and also make a lot of money. For example, let's say you buy an old property in an otherwise attractive neighborhood. The property needs cosmetic upgrades inside and outside the house. You invest \$30,000 into carefully chosen upgrades, such as better landscaping, paint, new flooring, a new kitchen, and new bathrooms. The \$30,000 investment in repairs may increase the value of the house by \$70,000 (this, of course, depends upon the particular situation). The \$40,000 difference is the forced appreciation.

Repairs are a typical way to force appreciation, but savvy investors also look for other opportunities. You may be able to increase density (like adding an extra rental unit), improve rental rates, decrease expenses, improve zoning, and more. All of these could potentially force the appreciation of a property.

Leverage

I already mentioned the use of debt (that is, leverage) when discussing equity buildup. But leverage in general can magnify all the other benefits mentioned here. For example, without leverage your \$100,000 in savings could only buy one property worth \$100,000. But with leverage, using an 80 percent mortgage (say, making a 20 percent down payment), you could instead buy five properties worth \$100,000 with \$20,000 down on each. All of the income, depreciation, equity, and appreciation benefits above would be magnified because of the leverage.

But keep in mind, leverage works both ways. Just like *benefits* are magnified with leverage, *losses* can also be magnified. I have personally seen more promising real estate investors go out of business because they couldn't make their debt payment than for any other reason. So a smart investor very carefully uses debt, if he or she uses it at all.

You've now learned the core benefits of real estate investing, but in the next chapter, let's look at four more reasons that aspiring early retirees should invest in real estate.

PROFILE OF A REAL ESTATE EARLY RETIREE

KAT HORN

Cashflow Kat (cashflowkat.com)

Location: Fredericksburg, Virginia

Chad's Favorite Quote from Kat:

"Steel your resolve and just go for it! You can get stuck in a loop of never-ending learning and searching."

WEALTH-BUILDING STATISTICS

- **Profession/Career:** Lawyer, broker, but primarily a stay-at-home mom
- **Income During Wealth-Building Phase:** \$150,000 to \$199,999/year
- **How Big a Role Did Real Estate Play in Wealth-Building?** Primary vehicle
- **Primary Real Estate Strategy(ies):** Long-term rentals, live-in flip

FINANCIAL INDEPENDENCE STATISTICS

- **Age at Financial Independence:** 41 to 45
- **Annual Expenses in Retirement:** Between \$75,000 to \$100,000
- **Ideal Number of Rentals in Retirement:** 6 to 10
- **Primary Source of Retirement Income:** Rental income
- **Secondary Source of Retirement Income:** Periodic sale of stocks, Social Security income, pension
- **Ideal Debt Level of Real Estate Portfolio:** Between 26% to 50% loan to value

Q&A

Q: Can you explain in more detail how you built your current wealth?

Although I've done two live-in flips, I have primarily focused on long-term buy and holds. I lived in many of the buy and holds prior to converting them to rental properties. Initially my husband and I purchased a home that needed work, and we ended up selling it quickly for a good profit when he was transferred unexpectedly. The flip was unintentional but advantageous. So we used that profit to buy another home that needed work. After remodeling it and living in it for several years, we made the deliberate decision to move out and convert it to a rental property. Once we did that successfully, it was hard to stop! We kept buying homes, living in them, fixing them up, and then turning them into rentals. In addition, however, we purchased two duplexes that we never resided in, because, after a few repairs, they both flowed cash immediately.

Q: What were the biggest obstacles and setbacks during your wealth-building stage? How did you overcome or push through them?

I think the biggest obstacle is always finding the money to do the next deal. Even though *you* know you can meet all of your mortgage obligations with your rents, lenders can be tough with their set debt-to-income requirements. So instead of getting too creative with hard-money loans or partnerships, I just kept building my real estate portfolio slowly. Every couple of years I was able to move forward and make another acquisition through traditional mortgage lending (especially since many of my properties were initially my primary residence). It was great to lock in long-term low-cost financing, and then watch over the years as my rents would continue to climb and my cash flow would continue to grow. That's the beauty of the long-term buy and hold, the numbers just keep getting better.

Q: What's your No. 1 best tip for those looking to build wealth with real estate investing?

Steel your resolve and just go for it! You can get stuck in a loop of never-ending learning and searching while being too intimidated to

just pull the trigger and make a rental property purchase. You have to push through the fear and take a chance. Just remember that you are not alone with your feelings, as most of us started in the same boat with the same fears and uncertainties. Taking action and getting started is the key.

Q: Can you explain in more detail your post-financial independence income? How do you plan on living off of this income?

My husband and I will have more rental income from our long-term buy and hold properties than from any other source in retirement. Happily, this rental income will be enhanced by his government pension (which will be equivalent to about 40 percent of his current salary). Then, for later years, we will be looking to 401(k) and IRA funds. Finally, there is Social Security ... but I can't say I'm counting on it! I'm concerned that by the time I am eligible to draw Social Security, it will be means-tested and I'll no longer have that as an income source. In fact, the lack of stability in Social Security is one huge reason to develop other income streams, like rental real estate.

Q: What concerns do you have for the future related to retirement income? How will you address that?

Honestly, I feel so secure because of my rental property income. Rising rents are a wonderful hedge against inflation. And in my own experience, even during the 2008 Great Recession, I didn't have to lower any of my rents. Also, my properties are located in several different markets that have all seen growth in populations and in their economies. Consequently, I feel as though I've put myself in a great position to weather future storms. As much as I like to gripe about landlord duties some days, I feel tremendously blessed that I began my real estate investing journey in my early thirties.

Q: Do you plan to start selling your real estate holdings? If so, when and how?

I will sell the residential properties once I no longer want to be bothered with the hands-on property management. Instead of hiring managers, I foresee selling most or all of the residential properties and

doing a 1031 exchange into something like a commercial triple-net lease property (or properties). I want to reap the tax advantages of a 1031 exchange and have a stable of properties that require little to no management. I also foresee placing them in a trust so that they will someday be assets for my children.

Q: What's your No. 1 best tip for those looking to live off of investment income after retirement/financial independence?

My tip is to structure your real estate investing to include at least some long-term buy and hold properties. Those are the properties that will provide the income stream and require less effort (hopefully!) as you retire and want to focus on other pursuits. I used to talk to my husband about doing short-term flips in retirement, but it's hard work. And I realized that I don't want to work that hard in retirement.